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A. General remarks

1. Introduction

(a) Purpose of private international law rules

1. This chapter discusses the rules for determining the law applicable to the creation, effectiveness against third parties ("third-party effectiveness"), priority as against the rights of competing claimants and enforcement of a security right (for the definitions of the terms "security right", "priority" and "competing claimant", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). These rules are generally referred to as private international law rules (or conflict-of-laws rules) and also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide relating to the priority of a security right, those rules will apply to a priority contest arising in the enacting State only to the extent that the private international law rule on priority issues points to the laws of that State. Should the private international law rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State.

2. The private international law rules proposed in the Guide will apply only if the forum is in a State that has enacted the recommendations of the Guide. They cannot apply in another State if the latter is not an enacting State. This is so because a State cannot legislate on the private international law rules to be applied in another State. The courts of the other State apply their own private international law rules. In order to determine whether to apply its domestic law or the law of another State, the court needs to determine whether a case is a domestic or an international case. This in itself may be considered as an issue of private international law. Unlike the United Nations Convention on the Assignment of Receivables in International Trade[1] (hereinafter referred to as the "United Nations Assignment Convention"), which defines "internationality", the Guide does not address the question, but rather leaves it to other law of the forum. In any case, for the law of a State to which private international law rules point to apply, there has to be a connection with that State. The main connecting factors addressed in this chapter are the location of the assets and the location of the grantor of a security right.

3. After a security right has been created and has become effective against third parties, a change might occur in the connecting factor. For instance, if the third-party effectiveness of a security right in inventory located in State A is governed under the private international law rules of State A by the law of the location of the inventory, the question arises as to what happens if part of the inventory is subsequently moved to State B (whose private international law rules also provide that the law of the location of tangible property governs the third-party effectiveness of security rights in tangible property). One approach would be for the security to

[1] United Nations publication, Sales No. E.04.V.4.

continue to be effective in State B without the need to take any further step in State B. Another approach would be for new security to be obtained under the laws of State B. Yet another approach would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). As this is a matter of substantive law rather than private international law, the Guide addresses it in chapter V (see A/CN.9/631, recommendation 46). This chapter deals only with the time that is relevant for the determination of the location of an asset or the grantor for the purpose of determining whether a security right has been created, made effective against third parties and obtained priority over another right (see A/CN.9/631, recommendation 216).

4. In an efficient secured transactions regime, private international law rules applicable to secured transactions normally reflect the objectives of the secured transactions regime. This means that the law applicable to the property aspects of a security right should be capable of easy determination. Certainty is a key objective in the development of rules affecting secured transactions both at the substantive and the private international law levels. Another objective is predictability. As illustrated by the example mentioned in the preceding paragraph, private international law rules should provide an answer to the question of whether a security right acquired under the law of State A remains subject to that law or becomes subject to the law of State B if a subsequent change in the connecting factor would point to the law of State B for a security right of the same type. A third key objective of an efficient private international law system is that the relevant rules reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties). In order to achieve this result, it is arguable that the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

5. Use of the Guide (including this chapter) in developing secured transactions laws will help to reduce the risks and costs resulting from divergences among current private international law regimes. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering an insolvency proceeding with respect to the grantor and its assets). If those States have different private international law rules in relation to the same type of encumbered asset, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized their private international law rules is that a creditor can rely on the same private international law rule (leading to the same results) to determine the status of its security in all those States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly held securities by the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, adopted by the Hague Conference on Private International Law in December 2002 (hereinafter the "Hague Securities Convention").

6. Private international law rules would be necessary even if all States had harmonized their substantive secured transactions laws. There would remain instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that a non-possessory right is

made effective against third parties by registration of a notice in a public registry, one would still need to know in which State's registry the registration must be made.

(b) Scope of private international law rules

7. This chapter does not define the security rights to which the private international law rules will apply. Normally, the characterization of a right as a security right for private international law purposes will reflect the substantive secured transactions law in a jurisdiction. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate private international law rule. The question arises, however, as to whether the private international law rules of a State relating to security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by the substantive secured transactions regime of that State (e.g. retention-of-title sales, financial leases and other similar transactions). The fact that the substantive secured transactions law of a State might not apply to those other transactions should not preclude the State from applying to those transactions the private international law rules applicable to secured transactions.

8. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, third-party effectiveness and priority of the transfer are the same as for a security right in the same type of property. An example is found in the United Nations Assignment Convention, which (including its private international law rules) applies to outright transfers of receivables as well as to security rights in receivables (see art. 2, subpara. (a) of the Convention). This policy choice is motivated, notably, by the necessity of referring to one single law to determine priority between competing claimants with a right in the same receivable. The Guide adopts the same policy. Otherwise, in the event of a priority dispute between a purchaser of a receivable and a creditor with a security right in the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the law of State A but the priority of the secured creditor were governed by the law of State B.

9. Whatever decision a jurisdiction makes on the range of transactions covered by the private international law rules, the scope of the rules on creation, third-party effectiveness and priority of a security right will be confined to the property aspects of the relevant transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the requirements to be met for a property right to be created in the encumbered assets. The rule would not apply to the personal obligations of the parties under their contract. In most legal systems, purely contractual obligations are generally subject to the law chosen by the parties in their agreement or, in the absence of such a choice, by the law governing the security agreement (e.g. the Convention on the Law Applicable to Contractual Obligations,[2] concluded in Rome in 1980, hereinafter the "Rome Convention"). The Guide recommends the same approach for the determination of the mutual rights and obligations of the grantor and the secured creditor with respect to the security right.

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[2] United Nations, *Treaty Series*, vol. 1605, No. 28023.

10. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the private international law rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For instance, the grantor and the secured creditor are normally not permitted to select the law applicable to priority, since this could not only affect the rights of third parties, but could also result in a priority contest between two competing security rights being subject to two different laws leading to opposite results.

11. The private international law rules of many legal systems now provide that reference to the law of another State as the law governing an issue refers to the law applicable in that State other than its private international law rules (see, however, A/CN.9/631, recommendations 219, subpara. (b), and 220). The doctrine of renvoi is excluded, for the sake of predictability and also because renvoi may run contrary to the expectations of the parties. The Guide adopts the same approach (see A/CN.9/631, recommendation 217).

2. Private international law rules for the creation, third-party effectiveness and priority of a security right

12. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis, as follows:

(a) The first issue is whether the security has been created (for matters covered by the notion of creation, see chapter IV of the Guide);

(b) The second issue is whether the security is effective against third parties (for matters covered by the notion of third-party effectiveness, see chapter V of the Guide); and

(c) The third issue is what is the priority ranking of the right of a secured creditor as against the right of a competing claimant, such as another creditor or an administrator in the insolvency of the grantor (for matters covered by the notion of priority, see chapter VII of the Guide).

13. Indeed, a security right is of little practical value if it cannot be efficiently enforced. This question does not, however, relate to the extent of the rights that the secured creditor has in the encumbered assets and the private international law rules on enforcement will be discussed in another section of this chapter.

14. Not all legal systems draw a distinction between effectiveness of a security right between the parties and effectiveness against third parties (and priority). In many legal systems, a validly created security right (or other property right) is by definition effective against all (*erga omnes*) without any further action. In those legal systems, the same private international law rule applies to the effectiveness of a security right against all (and priority may be analysed also as an issue of effectiveness). However, even legal systems that clearly distinguish among effectiveness as between the parties, effectiveness against third parties and priority do not always establish a separate private international law rule for each of those issues and thus the same private international law rule may apply to all the three issues leading to the application of the same substantive law rule.

15. Therefore, the key question is whether one single private international law rule should apply to all three issues. Policy considerations, such as simplicity and

certainty, favour the application of one private international law rule. As noted above, the distinction among these issues is not always made or understood in the same manner in all legal systems, with the result that providing different private international law rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding statutory security or similar rights (such as a judgement creditor or an insolvency administrator).

16. Another important question is whether on any given issue (i.e. creation, third-party effectiveness or priority) the relevant private international law rule should be the same for tangible and intangible property. A positive answer to that question would favour either a rule based on the law of the location of the grantor or a rule based on the law of the location of the encumbered assets (*lex situs* or *lex rei sitae*).

17. An approach based on the *lex situs* would be inconsistent in respect of receivables with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located). Moreover, as intangible property is not capable of physical possession, adopting the *lex situs* as the applicable private international law rule would require the development of special rules and legal fictions for the determination of the actual situation of the various types of intangible property. For this reason, the Guide does not consider the location of the asset as being the appropriate connecting factor for intangible property and favours an approach generally based on the law of the location of the grantor (see A/CN.9/631, recommendation 204).

18. In addition, consistency with the United Nations Assignment Convention would dictate defining the location of the grantor in the same way as in the Convention. Under the Convention, the grantor's location is its place of business or, if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see art. 5, subpara. (h) of the Convention). This approach was followed in the Convention mainly because it results in the application of a single law that is easy to determine and is the law of the State in which the main insolvency proceeding with respect to the assignor will most likely be opened.

19. Simplicity and certainty considerations could even support the adoption of the same private international law rule (e.g. the law of the grantor's location) not only for intangible property but also for tangible property, especially if the same law were to apply to the creation, third-party effectiveness and priority of a security right. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right in the same property governed by the law of State B).

20. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights in tangible property, at least for "non-mobile" goods (or even in certain types of intangible property, such as rights to

payment of funds credited to bank accounts or intellectual property, a matter discussed below). Moreover, adoption of the grantor's law would result in one law governing a secured transaction and another law governing a transfer of ownership in the same assets. To avoid this result, jurisdictions would need to adopt the grantor's law for all transfers.

21. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor's location were to be the general rule, an exception would need to be made for possessory security rights.

22. For all these reasons, the Guide recommends two general private international law rules on the law applicable to the creation, third-party effectiveness and priority of a security right, as follows:

(a) With respect to tangible property, the applicable law should be the law of the location of the assets (see A/CN.9/631, recommendation 202);

(b) With respect to intangible property, the applicable law should be the law of the location of the grantor (see A/CN.9/631, recommendation 204).

23. As the private international law rules generally will be different depending on the tangible or intangible character of the assets, the question arises as to which private international law rule is appropriate if intangible property is capable of being the subject of a possessory security right. In this regard, most legal systems assimilate certain categories of intangible property embodied in a document (such as a negotiable instrument) to tangible property, thereby recognizing that a possessory security right may be created in such assets through the delivery of the document to the creditor. The Guide treats these types of intangible property as tangible property (for the definition of "tangible property", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation) and, accordingly, the private international law rule for tangible property generally applies to such intangible property. Accordingly, the law of the State where the instrument is held will govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument (see A/CN.9/631, recommendation 202).

24. A related issue arises where goods are represented by a negotiable document of title (such as a bill of lading). It is generally accepted that a negotiable document of title is also assimilated to tangible property and may be the subject of a possessory pledge. The law of the location of the document (and not of the goods covered thereby) would then govern the pledge. The question arises, however, as to what law would apply to resolve a priority contest between a pledgee of a document of title and another creditor to whom the debtor might have granted a non-possessory security right in the goods themselves, if the document and the goods are not held in the same State. In such a case, the private international law rules should accord precedence to the law governing the pledge, on the basis that this solution would better reflect the legitimate expectations of interested parties. This result would also be consistent with the substantive rule proposed by the Guide (see A/CN.9/631, recommendation 107).

3. Law applicable to the creation, third-party effectiveness and priority of a security right in tangible property

25. The policy considerations favouring the general private international law rules set out above (see para. 22) do not necessarily apply in all circumstances and other rules apply with respect to certain specified types of asset for which the location of the asset or of the grantor is not the most appropriate connecting factor. In addition, for efficiency purposes, alternative rules apply with respect to goods in transit and export goods. Such goods are not intended to remain in their initial location and may cross the borders of several States before reaching their ultimate destination. The following paragraphs explain the two general private international law rules outlined above and their exceptions.

(a) General rule: law of the location of the encumbered asset (*lex situs* or *lex rei sitae*)

26. As mentioned above, the creation, the effectiveness against third parties and the priority of a security right in tangible property are generally governed by the law of the State in which the encumbered asset is located (see A/CN.9/631, recommendation 202). A frequent example of the application of the rule relates to security rights in inventory. If a grantor owns inventory located in a State that has this rule (State A), the law of that State will govern those issues. The rule also means that, if the grantor also owns other inventory in another State (State B), the relevant requirements of State B will have to be fulfilled in order for the courts of State A to recognize that the inventory located in State B is subject to the secured creditor's rights.

27. The general private international law rule for tangible property does not make a distinction between possessory security rights and non-possessory security rights. Accordingly, the law of the location of the asset will generally apply, whether or not the secured creditor has possession of the asset. This is particularly relevant for intangible property assimilated to tangible property, such as negotiable instruments and negotiable documents. For instance, the law of the location of the instrument or document will govern priority matters even if the security right is made effective against third parties otherwise than by possession.

(b) Additional rule for the creation and third-party effectiveness of a security right in goods in transit and export goods

28. With respect to goods in transit or goods intended for export, application of the law of the location of the goods results in the application of the law of the State in which the goods are located at the time an issue arises. This means that secured creditors have to monitor the assets and follow the requirements of various States to ensure that they have at all times an effective security right. To avoid that result, one approach would be for the forum in the ultimate (or intermediate) destination to recognize as effective a security right created and made effective against third parties under the law of the initial location. Such an approach would reflect the expectations of parties in the initial location of the goods, but would be contrary to the expectations of parties that relied on the actual location of the assets and provided credit to the grantor following the requirements of the law of the ultimate destination of the goods.

29. Another approach would be for the forum in the ultimate destination to recognize as effective a security right created and made effective against third parties under the law of the initial location of the goods for a limited period of time. Parties in the initial destination could then have a period of time to follow the requirements of the law of the State of the ultimate destination to retain their security right as originally created and made effective against third parties. Such an approach would balance the interests of parties in the various jurisdictions (and is in fact recommended in the Guide in general for all tangible property; see A/CN.9/631, recommendations 46 and 216).

30. A further approach would be to offer to the secured creditor the option of creating and making its security right effective against third parties under the law of the State of the initial location of the goods or under the law of the State of the ultimate (or intermediate) location of the goods (see A/CN.9/631, recommendation 203). This approach would allow a secured creditor that is confident that the goods will reach the place of their intended destination to rely on the law of that place to create and make its security right effective against third parties. Otherwise, in the case of a security right created while the goods are at their initial location, for the security right to be continuously effective against third parties, the secured creditor would have to fulfil the creation and third-party effectiveness requirements of the place of the initial location, of each State where the goods could be in transit and of the place of ultimate destination. In any case, priority would always be subject to the law of the location of the goods at the time a priority dispute arises.

(c) Special rule for the creation, third-party effectiveness and priority of a security right in a negotiable instrument

31. As mentioned above, it is generally accepted that the law of the State in which the instrument is located (*lex situs*) should govern the creation, third-party effectiveness and priority of a security right in a negotiable instrument. However, in some legal systems, the third-party effectiveness of a security right in negotiable instruments may also be achieved by registration in the place in which the grantor is located. In such a case, it is logical to rely on the law of the State of the grantor's location to determine whether third-party effectiveness has been achieved by registration. In any case, this approach is confined to third-party effectiveness achieved by registration. The law of the actual location of the instrument always governs the priority of a security right in the instrument (see A/CN.9/631, recommendation 207).

(d) Exceptions for certain types of asset

32. The general private international law rule for security rights in tangible property is normally subject to certain exceptions where the location of the property would not be an efficient connecting factor (e.g. goods ordinarily used in several States) or would not correspond to the reasonable expectations of the parties (e.g. goods the ownership of which must be recorded in special registries).

(i) Mobile goods

33. Mobile goods are goods that in the normal course of business cross the borders of States (e.g. aircraft, ships or, in some cases, motor vehicles). For example, a

grantor operating a construction business in several States may have to create security rights in machinery periodically moved from one State to another for the purposes of that business; or a grantor operating a transportation business may need to create security rights in the vehicles used in the transportation business (although motor vehicles may not normally cross national borders in island States). The application of the general private international law rule for tangible property of that kind would require the secured creditor to ascertain the exact location of each piece of machinery or each vehicle at the time of the creation of the security. To ensure continued third-party effectiveness of its security, the secured creditor would also need to enquire as to all States in which each of these assets might be potentially located at any given time and meet the relevant requirements of all such States. Moreover, it would not be possible to identify the State in which the relevant asset would be located at the time of a priority contest occurring in the future and therefore to determine the priority regime to be applied to resolve the dispute. To avoid these problems and resulting costs and uncertainties, in many legal systems, the creation, third-party effectiveness and priority of a security right in tangible property of a type ordinarily used in more than one State are governed by the law of the State in which the grantor is located (except if ownership of property of that type is subject to registration in a special registry which also allows for the registration of security rights; see para. 34 below; see also A/CN.9/631, recommendation 202).

(ii) Tangible property subject to specialized registration

34. The ownership of certain categories of tangible property is sometimes recorded in specialized registries. This is generally the case for aircraft and ships and, in some States, for motor vehicles. To the extent that the relevant registry also permits the registration of security rights, reference can be made to the law of the State under the authority of which the relevant registry is maintained to determine the law governing the creation, third-party effectiveness and priority of a security right in an asset that is subject to registration in such a specialized registry. Thus, a search in the registry would disclose both ownership and security rights in respect of such assets. Such a rule may be based on national law (see A/CN.9/631, recommendation 202) or international conventions, which take precedence (e.g. the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment and the relevant protocols thereto).

4. Law applicable to the creation, third-party effectiveness and priority of a security right in intangible property

(a) General rule: law of the location of the grantor

35. In some legal systems, the law of the State in which the grantor is located governs the creation, third-party effectiveness and priority of a security right in intangible property. For instance, if an exporter located in State A creates a security right in receivables owed by customers located in States B and C, the law of State A will govern the property right aspects of the security right. This rule is consistent with the approach followed in the United Nations Assignment Convention with respect to the law applicable to the assignment of receivables (see arts. 22 and 30).

36. In other legal systems, the law of the location of the asset still governs the creation, third-party effectiveness and priority of a security right in intangible assets. In those legal systems, it is necessary to establish the location of an intangible asset (e.g. for a receivable, the location of the debtor of the receivable). In those legal systems, the law of the location of the intangible asset (*lex situs*) governs all those matters.

37. The law of the grantor's location has several advantages over the *lex situs*. It is one law, as the assignor is always one and the same person even if the assignment relates to many receivables owed by different debtors (subsequent assignments, from A to B and from B to C, do not raise priority issues, as one assignor takes the place of another). In addition, the law of the grantor's location may be ascertained easily at the time the assignment is made, even if the assignment relates to future receivables or to receivables assigned in bulk. Moreover, the law of the grantor's location (place of central administration in the case of places of business in more than one State) is the law of the State in which the main insolvency proceeding with respect to the assignor is likely to be opened.

38. Moreover, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible property, great difficulties arise in applying the *lex situs* to intangible property, both at conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable. One view is that it is the place where payment must be made. Another view is that the *situs* of a receivable is the legal domicile or place of business or principal residence of the debtor of the receivable. A further view is that a receivable should be deemed to be located in the State whose law governs the contractual relationship between the original creditor (that is, the grantor) and the debtor. Any of the foregoing alternatives would impose upon a prospective assignee the burden of having to make a detailed factual and legal investigation. Moreover, in many instances, it might prove impossible for the assignee to determine with certainty the exact location of a receivable since the criteria for determining that location may depend on business practices or the will of the parties to the contract under which the receivable arises. Thus, using the *lex situs* as the law applicable to security rights involving receivables would not provide certainty and predictability, which are key objectives for a sound private international law regime in the area of secured transactions.

39. Furthermore, even if a legal system has detailed provisions allowing a prospective or existing secured creditor to ascertain easily and objectively the law of the location of a receivable, practical difficulties still ensue in many commercial transactions. This would be so because a security right may relate not only to an existing and specifically identified receivable, but also to many other receivables. Thus, a security right may cover a pool of present and future receivables. For instance, in such a case, selecting the *lex situs* as the law governing priority would not be an efficient policy decision, as different priority rules might apply with respect to the various assigned receivables. Moreover, where future receivables are subject to a security right, it would not be possible for the secured creditor to ascertain the extent of its priority rights at the time of the transaction, since the *situs* of those future receivables is unknown at that time.

40. In view of the above, the Guide recommends the law of the State in which the grantor is located (see A/CN.9/631, recommendation 204). The criteria defining the

grantor's location are consistent with those found in the United Nations Assignment Convention (see A/CN.9/631, recommendation 215).

(b) Exceptions for certain types of asset

41. There are three categories of intangible property to which different considerations apply and the location of the grantor is not the most (or the only) appropriate connecting factor for the selection of the applicable law: rights to payment of funds credited to a bank account; proceeds under an independent undertaking; and receivables arising from a transaction relating to immovable property.

(i) Rights to payment of funds credited to a bank account

42. With respect to the creation, third-party effectiveness, priority and enforcement of a security right in rights to payment of funds credited to a bank account, as well as the rights and obligations of a depositary bank, different approaches are followed in various legal systems (for the definition of "bank account", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). One approach is to refer those matters to the law of the State in which the branch maintaining the account is located. Under this approach, certainty and transparency with regard to the applicable law would be enhanced, as the location of the relevant branch could be easily determined in a bilateral bank-client relationship. In addition, such an approach would reflect the normal expectations of parties to current banking transactions. Moreover, this approach would result in the application of the same law to all issues (e.g. loans and tax or regulatory matters) relating to banking activities.

43. Another approach is to refer to the law specified in the account agreement as the law governing the account agreement or to any other law explicitly specified in the account agreement, provided that the depositary bank has a branch in that State. If the account agreement does not specify any law, the applicable law would be determined using the same default criteria as those found in article 5 of the Hague Securities Convention. Under this approach, the applicable law would meet the expectations of the parties to the account agreement. In addition, the need to identify the location of a bank account, which might not be easy to determine, would be avoided. Moreover, third parties would be able to ascertain the law provided in the account agreement, as the grantor-account holder would normally supply information on the account agreement to obtain credit from a lender relying on the funds in the account.

44. As is the case with negotiable instruments, the law of the State of the grantor's location could apply to the third-party effectiveness of a security right in a right to payment of funds credited to a bank account where third-party effectiveness may be achieved by registration in the place where the grantor has its location (see para. 31 above).

(ii) Proceeds under an independent undertaking

45. In many legal systems, the third-party effectiveness, priority and enforcement of a security right in proceeds under an independent undertaking, as well as the rights and duties of a guarantor/issuer, confirmer or nominated person, are referred

to the law specified in the independent undertaking (for the definition of "right in proceeds under an independent undertaking", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation; for this approach, see A/CN.9/631, recommendation 208). If the governing law is not specified in the independent undertaking, those matters are referred to the law of the State of the location of the relevant office of the person that has provided (or has agreed to perform, as the case may be) the undertaking (see A/CN.9/631, recommendation 209). This approach provides certainty and predictability with respect to the law applicable to those matters. It is also consistent with the normal expectations of parties to such transactions. As to the creation of a security right in such an asset, reference is made to the law of the grantor's location, for the reasons discussed above with respect to security rights in receivables and in view of the fact that creation involves just the effectiveness of the security right as between the parties to the security agreement and does not affect the rights of third parties.

46. With the exception of creation, the matters mentioned in the preceding paragraph are governed by the law governing a receivable or negotiable instrument, if an independent undertaking is issued to ensure the performance of an obligation under the receivable or the negotiable instrument and, under the applicable law, the creditor with a right in the receivable, negotiable instrument or other intangible asset automatically has the benefit of the security right in the proceeds under the independent undertaking (see A/CN.9/631, recommendation 210). This approach is justified by the need to have, for consistency reasons, the same law apply to the security right in a receivable or negotiable instrument extending automatically to rights securing the performance of the receivable or negotiable instrument.

(iii) Receivables related to immovable property

47. Where a receivable arises from the sale or lease of immovable property or is secured by immovable property, as for any other receivable, the law of the State of the location of the grantor will normally govern the property aspects of a security right in the receivable. However, in the event of a priority contest where at least one of the competing claimants has registered its right in the immovable property registry of the State in which the property is located, the priority contest will be resolved in accordance with the law of that State (see A/CN.9/631, recommendation 205).

5. Law applicable to the creation, third-party effectiveness and priority of a security right in proceeds

48. There are generally two approaches to the law applicable to the creation, third-party effectiveness and priority of a security right in proceeds (for the definition of "proceeds", see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

49. One approach is to refer for the law applicable to a security right in proceeds to the law applicable to the security right in the original encumbered assets. For example, if the original encumbered assets are in the form of inventory located in State A and the proceeds take the form of receivables and the grantor is located in State B, the law of State A would apply to the creation, third-party effectiveness and priority of a security right in receivables. In particular, a priority conflict between a security right in receivables as proceeds of inventory and a security right in

receivables as original encumbered assets would be governed by the law of State A (the law of the location of the inventory). As a result, certainty as to the applicable law would be enhanced for the benefit of the inventory financiers relying on the receivables as proceeds. On the other hand, this approach would result in the application of a law other than the law receivables financiers would expect to apply to their rights in the receivables as original encumbered assets.

50. Another disadvantage of this approach is that the receivables financier would be unable to predict what the applicable law would be because the choice of the governing law would depend on whether the dispute arises with an inventory financier (in which case the law of the location of the inventory would govern) or with another competing claimant (in which case the law of the location of the grantor would govern). This approach also provides no solution in a tripartite dispute among the receivables financier, the inventory financier and another competing claimant. This approach would also undermine the choice of the law of the grantor's location as the law applicable to a security right in receivables because receivables often result from the sale of tangible assets. The receivables financier in many instances then would be unable to rely on the law of grantor's location.

51. Another approach is to refer to the law applicable to security rights in assets of the same type as the proceeds. In the example given above, the law of State B (the law of the grantor's location) would apply to the creation, third-party effectiveness and priority of a security right in the receivables. Simplicity and certainty considerations would support such an approach. The benefit of this approach is that it would always be possible to determine the applicable law irrespective of the parties to the dispute.

52. Yet another approach is to combine the two approaches mentioned above and have the latter approach as the rule for third-party effectiveness and priority of a security right in proceeds, while the former approach would apply to the creation of that right. Under this approach, the question of whether a security right extends to proceeds would be governed by the law applicable to the creation of a right in the original encumbered assets from which the proceeds arose, while the third-party effectiveness and priority of an entitlement to proceeds would be subject to the law that would have been applicable to such issues if the proceeds had been original encumbered assets. This approach would meet the expectations of a creditor obtaining a security right in inventory under a domestic law providing that such security right automatically extends to proceeds. It would also meet the expectations of receivables financiers as to the law that would apply to the creation, third-party effectiveness and priority of a security right in receivables as original encumbered assets. Finally, such an approach would ensure that the inventory financier could rely on the law governing its security right as to whether the right extends to proceeds and would allow all competing claimants to identify with certainty the law that will govern a potential priority contest (see A/CN.9/631, recommendation 211).

6. Law applicable to the rights and obligations of the parties to the security agreement

53. As mentioned above (see para. 9), the scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (*in rem*) aspects of the right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are

rather governed by the law chosen by them or, in the absence of a choice of law, by the law governing the agreement as determined by the private international law rules generally applicable to contractual obligations (see A/CN.9/631, recommendation 212). For example, in the absence of a choice of law by the parties, the mutual rights and obligations of the parties to the security agreement may be subject to the law most closely connected to the security agreement (see art. 4, para. 1, of the Rome Convention). A security agreement securing a loan may be presumed to be most closely connected with the State in which the party that performs the obligation that is characteristic of the security agreement has its central administration or habitual residence (see art. 4, para. 2, of the Rome Convention). In such a security agreement, this party may be the lender. In a retention-of-title sale, it may be the seller.

7. Law applicable to the rights and obligations of third-party obligors

54. Security rights in intangible property generally involve third parties such as, for example, the debtor of a receivable, the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document. The private international law rules governing the property aspects or the enforcement of a security right are not necessarily appropriate for the determination of the law applicable to the obligations of third parties against whom the secured creditor may want to exercise the remedies arising from its security right. The main reason is to avoid frustrating the expectations of parties that have a payment obligation arising in connection with the encumbered asset but do not take part in the transaction to which the security agreement relates.

55. In particular, the fact that a receivable has been encumbered by a security right should not result in the obligations of the debtor of the receivable becoming subject to a law different from the law governing the receivable. Similar considerations apply to rights of the obligor under a negotiable instrument, the depositary bank, the guarantor/issuer, confirmer or nominated person in an independent undertaking or the issuer of a negotiable document where the encumbered asset is a negotiable instrument, right to payment of funds credited to bank accounts or proceeds under an independent undertaking, or a negotiable document (see A/CN.9/631, recommendations 206, 208 and 213).

8. Law applicable to the enforcement of a security right

56. In most legal systems, procedural matters are governed by the law of the State where the relevant procedural step is taken. However, enforcement may relate to substantive or procedural matters. Although a court would use its own law to determine what is substantive and what is procedural, the following are examples of issues generally considered to be substantive: the nature and extent of the remedies available to the creditor to realize the encumbered assets; whether such remedies (or some of them) may be exercised without judicial process; the conditions to be met for the secured creditor to be entitled to obtain possession and dispose of the assets (or to cause the assets to be judicially realized); the power of the secured creditor to collect receivables that are encumbered assets; and the obligations of the secured creditor to the other creditors of the grantor.

57. So, with respect to substantive enforcement matters, where a security right is created and made effective against third parties under the law of one State, but is sought to be enforced in another State, the question arises as to the law applicable and thus the remedies available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security right could allow enforcement by the secured creditor without prior recourse to the judicial system unless certain conditions for the protection of the grantor are met, while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

58. One approach would be to refer enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The place of enforcement of security rights in tangible property in most instances would be the place of the location of the asset, while enforcement of a security right in intangible property would often take place in the location of the grantor. The policy reasons in favour of this rule include that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the law of the State in which the property being the object of the enforcement is located (and could also coincide with the law governing priority if the private international law rules of the relevant State point to such location for priority issues);

(c) The requirements would be the same for all creditors intending to exercise rights against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

59. On the other hand, selecting the *lex fori* may result in uncertainty if the encumbered asset consists of intangible property. For example, it is not clear where enforcement is to take place if the encumbered assets are in the form of receivables. The answer to this question would be very problematic as it would require the criteria for determining the location of the receivables to be set out (see para. 38 above). In addition, the secured creditor might be located in a different State at the time the initial enforcement steps are taken. In the case of a bulk assignment involving receivables connected with several States, multiple laws may apply to enforcement. The result would be the same if one enforcement act would have to be performed in one State (e.g. notification of the debtor of the receivable) and another act in another State (e.g. collection or sale of the receivable). If future receivables are involved, the secured creditor may not know at the time of the assignment which law would govern its enforcement remedies. All this uncertainty as to the applicable law is likely to have a negative impact on the availability and the cost of credit.

60. Another concern is that the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the priority of the security right will be determined. For example, if extrajudicial enforcement is permitted under the law governing the priority of the security right, this remedy should also be available to the secured creditor in the State where it has to enforce its security right, even if it is not generally allowed under the domestic law of that State.

61. So, another approach would be to refer substantive enforcement matters to the law governing the priority of the security right. The advantage of such an approach would be that such matters are closely connected with priority issues (e.g. the manner in which a secured creditor will enforce its security right may have an impact on the rights of competing claimants). Such an approach may have another benefit. As the law governing priority is often the same law as the law governing the creation and third-party effectiveness of the security right, the end result would be that creation, third-party effectiveness, priority and enforcement issues would often be governed by the same law.

62. A third possible approach would be to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with the law applicable to the creation of the security right since that law is often selected as also being the law of their contractual obligations. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation, third-party effectiveness and priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

63. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum, or of the law governing creation, third-party effectiveness and priority.

64. Another approach would be to attempt to reconcile the benefits of the approaches based on the *lex fori* and the law governing priority. Under this approach, the enforcement of a security right in tangible property may be governed by the *lex fori*, while the enforcement of a security right in intangible property would be governed by the same law as the law that applies to priority (see A/CN.9/631, recommendation 214).

9. Rules and relevant time for the determination of location

65. As the general private international law rules for security rights in tangible and intangible property point to the location of the encumbered assets and the location of the grantor, respectively, it is essential that the appropriate location be easily identified. Tangible property is commonly viewed as being located at the place where it is physically located and there is no need to provide a specific rule to that effect. There is such a need, however, for the determination of the location of the grantor. The legal domicile and the residence of a natural person might be in different States. Likewise, a legal person may have its statutory head office in a State other than the State in which its principal place of business or decision centre is located.

66. As mentioned above, the United Nations Assignment Convention defines the location of the grantor as follows: the grantor's location is its place of business or if the grantor has places of business in more than one State, the place where the central administration of the grantor is exercised. If the grantor has no place of business, reference is then made to the grantor's habitual residence (see art. 5,

subpara. (h)). The Guide defines the location of the grantor in the same manner (see A/CN.9/631, recommendation 215).

67. Whatever connecting factor is retained for determining the most appropriate private international law rule for any given issue, there may be a change in the relevant factor after a security right has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law is the law of the jurisdiction where the encumbered assets are located, the assets may be moved to another jurisdiction. So, it is necessary to determine the time that is relevant for the determination of location.

68. If this issue is not dealt with specifically, the general private international law rules on creation, third-party effectiveness and priority might be construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to creation issues (because they arose before the change, while the subsequent governing law would apply to events occurring thereafter that raise third-party effectiveness or priority issues). For instance, in a situation where the law applicable to the third-party effectiveness of a security right is that of the grantor's location, the effectiveness of the right against the insolvency administrator of the grantor would be determined using the law of the State of the new location of the grantor at the time of commencement of the insolvency proceedings.

69. Silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation as between the parties in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the grantor are entitled to determine the applicable law for all issues relying on the actual connecting factor, being the connecting factor in effect at the time of their dealings).

70. Therefore, providing guidance on these issues would appear to be necessary to avoid uncertainty, as a change in the connecting factor will result in the application of a law other than the law expected by the parties to apply if the law of the new location of the assets or the grantor has a different private international law rule. Normally, for the purpose of determining the law applicable to creation, the relevant location is the location of the encumbered asset or the grantor at the time of creation. For the purpose of determining the law applicable to third-party effectiveness and priority, the relevant location is the location at the time the issue arises (see A/CN.9/631, recommendation 216).

10. Public policy and internationally mandatory rules

71. According to generally applicable private international law rules, the forum may refuse the application of the law applicable under its private international law rules only if the effect of its application would be manifestly contrary to the public policy of the forum State or in a situation where such effects are contrary to mandatory provisions of the law of the forum. This rule is intended to preserve fundamental principles of justice of the forum State. For example, if, under the law of the forum State, a security right cannot be created in retirement benefits and this is a matter of public policy or mandatory law in the forum State, the forum State

may refuse to apply a provision of the applicable law that would recognize such a right. However, the forum may not apply instead its own law to third-party effectiveness or priority issues, unless the law of the forum is the applicable law (see A/CN.9/631, recommendation 218). This approach is justified by the need to avoid undermining certainty with respect to the law applicable to third-party effectiveness and priority. The same approach is followed in articles 23, paragraph 2, 30, paragraph 2, and 31 of the United Nations Assignment Convention. It is also followed in article 11, paragraph 3, of the Hague Securities Convention.

11. Special rules when the applicable law is the law of a multi-unit State

72. The term "State" in the Guide refers to a sovereign State or country. The question arises, however, as to what law applies if on a given issue the private international law rule refers to a State that comprises more than one territorial unit, with each unit having its own system of law in relation to the issue. This could be the case in federal States in which the secured transactions law generally falls under the legislative authority of their territorial units. For the private international law rules to work when the applicable law is the law of such a State (even if the forum is not a multi-unit State), it is necessary to determine the territorial unit whose law will apply.

73. Normally, references to the law of such a State are to the law in effect in the relevant territorial unit, as determined on the basis of the applicable connecting factor (such as the location of the asset or the location of the grantor). For instance, if the applicable law is the law of a multi-unit State with three territorial units (A, B and C), a reference to the law of the location of the grantor as the law applicable to a security right in receivables means a reference to the law of unit A if the place of central administration of the grantor is in unit A (see A/CN.9/631, recommendation 219, subpara. (a)).

74. To preserve the consistency of the internal private international law rules of a multi-unit State, it is generally provided that such rules continue to apply, but only internally (see A/CN.9/631, recommendations 219, subpara. (b), and 220). Using the example given in the preceding paragraph, if a grantor is located in unit A of a multi-unit State, application of the law of unit B would be permitted where the internal conflict rules of unit A would point to the law of unit B as the applicable law. This could be the case if the conflict rules of unit A contemplate (as in the Guide) that the law of the grantor's location governs the third-party effectiveness and priority of a security right in receivables but defines location differently. If the location of the grantor as defined in the Guide (that is, the place of central administration) is in unit A but the law of unit A defines the grantor's location as meaning the location of its statutory head office and the head office of the grantor is in unit B, then the third-party effectiveness and priority of the security right in the receivables will be governed by the law of unit B. This appears to be a deviation from the general rule on the exclusion of renvoi (see A/CN.9/631, recommendation 217). However, this "deviation" is limited to internal renvoi, which does not affect certainty as to the applicable law. In the above example, there would be no reference to a law other than that of unit A should the statutory head office of the grantor be located in a State other than the State of which unit A forms part.

75. These rules apply only to issues that, in the relevant multi-unit State, are governed by the laws of its territorial units. These rules would have no impact in a

federal State whose constitution provides that secured transaction matters are governed by federal laws. These rules would not apply either if the applicable law is the law of a State with multiple units and multiple jurisdictions in which application of such a renvoi could inadvertently result in uncertainty as to the applicable law.

B. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter*.]